THE LIFO COALITION

1325 G Street N.W., Suite 1000, Washington, DC 20005 ▪ TEL: 202-872-0885

October 15, 2009

To The President's Economic Recovery Advisory Board:

The LIFO Coalition is pleased to provide the following comments in response to a request for comments from the President's Economic Recovery Advisory Board ("PERAB"), with respect to potential ideas for tax reform.

The LIFO Coalition represents over 100 trade associations and companies comprising a wide variety of businesses of different sizes and from a broad cross-section of industry sectors which employ the last-in, first out (LIFO) inventory method. A copy of The LIFO Coalition's membership list is attached.

The reason that The LIFO Coalition is providing these comments is that earlier this year, the President proposed the repeal of the LIFO inventory method in his budget submission to Congress; and the Senate Finance Committee referenced repeal as a revenue raiser to help offset the cost of expanding health insurance coverage and reforming health care in the United States. While the proposal to repeal the LIFO inventory method has not been included in any of the bills pending in Congress relating to health care reform, The LIFO Coalition presumes that PERAB will be giving consideration in its tax reform deliberations to any tax proposal, including the proposal to repeal the LIFO inventory method, which was included in the President's budget submission to Congress, despite the fact that such proposals were not adopted by Congress in the context of health care reform.

In this regard, The LIFO Coalition wishes to take this opportunity to express its view that PERAB should reject any proposal to repeal the LIFO inventory method. The LIFO Coalition offers the following reasons in support of this position.

Background -- What is the LIFO Inventory Method?

When a business is engaged in the sale of merchandise that was either produced by that business or purchased for resale, it is necessary both for financial reporting purposes and for federal income tax purposes to measure the business's net income realized from the sale of that merchandise. Net income from the sale of merchandise is calculated by reducing the revenue earned by the business from the sale of the merchandise by the cost of the merchandise, as well as other direct and indirect expenses of operating the business. The cost of the merchandise sold is typically the largest single deduction in the calculation of net income from the sale of merchandise.

When a business either purchases merchandise for resale or manufactures merchandise for sale, not all of the merchandise purchased or produced by the business during the year is typically sold by the end of the year in which merchandise was purchased or produced, so that unsold merchandise is included in the ending inventory of the business. Since merchandise is fungible and not normally subject to physical tracking, it is therefore necessary for a business to adopt some type of methodology for determining the cost of merchandise sold and establishing the cost of the unsold merchandise remaining in the business' inventory at the end of the year. This is where inventory valuation methods are used.

For the past 70 years, there have been two main methods of valuing a business' ending inventory and determining the cost of merchandise sold -- FIFO and LIFO. Both inventory methods are widely used and have been generally accepted both for financial reporting purposes and for tax purposes. Under the FIFO method, it is assumed that the cost of the merchandise that is sold during the year is the cost of the earliest merchandise purchased or produced, so that the cost of unsold merchandise remaining in a business' inventory at the end of the year is assumed to be the cost of the latest merchandise purchased or produced during the year. Under the LIFO method, the reverse assumption is adopted. Thus, under the LIFO method, it is assumed that the cost of the merchandise that is sold during the year is the latest merchandise purchased or produced during the year, so that the cost of the unsold merchandise remaining in a business' inventory at the end of the year is the cost of the earliest merchandise purchased or produced.

Since merchandise is not physically sold in any particular chronological order, the question comes to mind why either of these two accounting conventions for calculating inventory and cost of goods sold is permitted. The reasons are two-fold. First, most merchandise is fungible and it is not practicable to track the flow of merchandise through inventory by specific identification. Second, depending on whether prices of merchandise are rising or falling, one of the two methods provides a fairer measure of the net income of the business depending on the direction of prices. When prices are stable, both methods produce the same result, so that the effect of the methods on net income is neutral.

In an environment when prices are rising, economists and accountants have maintained that if, in order to remain in business, an enterprise must take the profits that are earned from the previous sale of merchandise and reinvest those profits in the rising cost of the next merchandise to be purchased or produced, it is not accurate to depict the enterprise's net income as including the portion of the increased profit that results from sales of merchandise simply due to increasing prices, when those increased profits are simply tied up in an increased investment in the same amount of inventory. In fact, to maintain the business and create the LIFO reserve, the entire amount of the reserve, including the deferred tax, must be invested in inventories. For a business in this type of environment of rising prices, the LIFO inventory produces a fairer reflection of income. Congress agrees with this assessment and has for 70 years permitted the use of the LIFO inventory method for tax purposes.

Conversely, for industries which sell products which tend to decline in cost, it has been argued that the FIFO inventory method produces the fairer reflection of net income. Thus, in an environment of falling prices, businesses typically tend to elect to use the FIFO inventory method. This situation has occurred, for example, in such industries as electronics and computers, which explains why these types of businesses typically use the FIFO inventory method. As in the case of the LIFO inventory method, the FIFO inventory method has also been recognized by Congress as an acceptable method of inventory valuation.

In summary, Congress has long permitted businesses to use either the LIFO inventory method or the FIFO inventory method for tax purposes, recognizing that a business' choice of methods will be dictated by whether prices are rising or falling, as long as the method selected is used consistently. By making the appropriate choice of method, a business is thus permitted to assume that the less expensive inventory remains on hand for the calculation of taxable income. By matching current costs against current revenues, these inventory regimes most accurately measure the net income (or loss) of a business, by reference to how much the business spent during the year.

Does LIFO Produce a Permanent Deferral of Income

A few critics of the LIFO inventory method have noted in their opposition that the LIFO inventory method was originally intended as a temporary deferral of income. However, these critics allege that experience has shown that the LIFO inventory method produces a permanent deferral of income.

This criticism is misplaced and demonstrates the critics' lack of understanding of the way the LIFO inventory method was intended to operate. As noted above, the LIFO inventory method is designed to postpone the reporting of the portion of a business' profits that is due to inflation, where that inflationary profit is simply reinvested in the next purchase or production of merchandise in order to replace the merchandise that has been sold. The measure of this postponement of income is referred to as a business' LIFO reserve.

Thus, under the LIFO inventory method, a business' LIFO reserve is reduced, thereby reversing the postponement of profit, when either of two events occurs. First, when prices of merchandise decline, a business' LIFO reserve is correspondingly reduced and its reported income is increased. Second, when a business' inventory levels are permanently reduced, the business' LIFO reserve is also reduced and its reported income is increased.

Both of these triggering events demonstrate that the LIFO method is functioning as it was intended. If prices of merchandise decline, the need for a business to reinvest a portion of its inflationary profit in replacement inventory dissipates with the discontinuance of inflation. Likewise, a business' need to permanently reinvest its inflationary profit in replacement inventory no longer exists where a business permanently reduces its inventory levels or discontinues its business altogether. In contrast, requiring a business to terminate the use of LIFO and repay its LIFO reserve before either of those events has occurred, as the critics would suggest, runs counter to the basic reason for the use of LIFO and forces a business to pay taxes out of its permanently invested capital.

Who Uses the LIFO Inventory Method?

Recently, a few commentators have leveled the charge that the LIFO inventory method is a preferential method that is used by only a relatively few taxpayers in a few limited industries. This assertion is completely untrue. In fact, LIFO is used by many tens of thousands of companies across numerous industries.

As is demonstrated by the diversity of industries that are represented in the membership of The LIFO Coalition, the LIFO inventory method is used in wide variety of industries embodying manufacturing, wholesaling and retailing. Industries in which the LIFO inventory method is used extensively include such basic manufacturing industries as iron and steel, chemicals, petroleum, alcoholic and non-alcoholic beverages, motor vehicles and transportation equipment, construction equipment, pharmaceuticals, tobacco, food products, machinery and specialty tools and apparel. In the wholesale distribution and retail industries, there is widespread use of the LIFO method by food, drug and medical wholesalers, building material and construction supply distributors, newspapers, automobile and equipment dealers, beverage dealers, grocery and department stores and discount and specialty retail stores.

Moreover, the spectrum of users of the LIFO inventory method includes both large, publicly-held corporations and small, privately-held organizations. In fact, the use of the LIFO method is particularly widespread among sole proprietorships, partnerships and S corporations that are taxed at individual tax rates. LIFO is particularly important to these types of businesses which have thin capitalization, small profit margins, and/or are particularly sensitive to rising materials costs. Moreover, the suggestion by some commentators that the right to use the LIFO inventory method be exchanged for a reduction in corporate tax rates, while individual tax rates are permitted to rise, would represent a “double whammy” to small business users of the LIFO inventory method which are taxed at individual tax rates.

Devastating Impact of Retroactive Repeal

While the revenue estimates that have circulated estimating the revenue effect from the repeal of the LIFO inventory method vary widely, the magnitude of the effect is uniformly substantial. Looking behind these revenue estimates, it is obvious that the overwhelming majority of the revenue raised from the repeal of the LIFO inventory method would come not from the future elimination of its use, but from the “recapture” tax on accumulated LIFO reserves, i.e., from the requirement that the full amount of LIFO reserves be taken into income and taxed over a period of years. As noted above, a business’ LIFO reserve is not an accumulation of company funds, but rather is a figure that the business is required to compute and record. The figure represents the cumulative amount by which the deductions the business has taken over the years under the LIFO inventory method exceed the deductions that would have been available to the business had the business used the FIFO inventory method. Under the recapture feature of LIFO repeal, the entirety of this amount would be taxed as income.

It is difficult to overstate the magnitude of the impact of this feature of LIFO repeal on individual businesses. The way the LIFO method operates is that while the LIFO reserve fluctuates over time, the LIFO reserve gradually increases over time. Most businesses which use the LIFO inventory method have used such method for several decades. As a result, it would not be unusual for an individual business’ LIFO reserve to exceed its average annual taxable income by five or ten times. This means that repeal of the LIFO inventory method could increase a business’ income tax liability five- or ten-fold. Regardless of the number of years over which that increased tax liability would be spread, the magnitude of the additional tax for any business would be enormous.

Moreover, the degree of retroactivity associated with LIFO reserve recapture needs to be fully appreciated. Since, as indicated, a company’s LIFO reserve consists of the amount by which the company’s deductions under LIFO exceed the deductions that would have been available under FIFO, the taxing of that amount as income effectively constitutes a retroactive repeal of the deductions that make up that increment. Many of these deductions were taken as many as 50, 60 or 70 years ago. The businesses that took these deductions did so in reliance on the Internal Revenue Code’s LIFO provisions, which provide that a company’s LIFO reserve – i.e., the entirety of these incremental deductions – will not be taken into income in the normal course of events unless the company voluntarily changes its inventory accounting method. By requiring that these decades-old deductions be repealed in the absence of such voluntary action, repeal of the LIFO inventory method incorporates a degree of retroactivity that The LIFO Coalition submits is unprecedented in the history of the Tax Code. Accordingly, The LIFO Coalition does not think it unfair to characterize any such proposal to repeal the LIFO inventory method as punitive.

In addition, if the LIFO method is repealed, businesses operating in a market prone to rising prices will be forced to begin paying income taxes on unrecognized phantom inflation-caused "profits." In the long run, most economists predict a return to significant inflation as a result of the stimulating effects of the Federal Government's injection of capital into the marketplace. In these circumstances, the repeal of the LIFO inventory method could result in many businesses having the replacement cost of their merchandise exceed their after-tax income from the sale of that merchandise, obviously an unsustainable situation.

Thus, while the repeal of the LIFO inventory method might seem like a substantial revenue raiser for the Government, The LIFO Coalition firmly believes that the long-term damage to the economy that would result would far out-weigh any short term increase in revenue. Based on the feedback The LIFO Coalition members have received from their member companies, repeal of the LIFO inventory method would have a devastating impact on the economy, as businesses would be forced to lay off workers, stop providing health insurance or contributing to retirement plans, and cancel planned investments or hiring. For some companies – especially small businesses – repeal of the LIFO inventory method would force them out of business entirely: the LIFO reserve could exceed retained earnings or net worth, in which case the business probably would liquidate, and might still owe tax. While some larger businesses might have the financial capacity to absorb the tax increase, they would nonetheless be similarly harmed by the resultant reduction in shareholder equity and stock price. And businesses of all sizes could find themselves in violation of their financing and loan covenants.

The LIFO Coalition Urges PERAB Not to Propose the Repeal of the LIFO Inventory Method

In conclusion, the LIFO inventory method is not some tax "gimmick" employed to advantage a select few taxpayers. It is a well-accepted method of accounting used by many tens of thousands of businesses to track their costs and accurately measure their income for tax and financial reporting purposes. The repeal of the LIFO inventory method would result in:

- a punitive tax on business that would force businesses to generate sufficient cash to pay tax on deemed, non-existent income;
- serious unfairness to taxpayers, given the historically unprecedented retroactivity associated with proposed LIFO repeal;
- bad tax policy that would prevent businesses from being properly taxed on their real income; and
- bad economic policy that, even in a good economy, would result in job losses and decreased capital spending and investment.

The LIFO Coalition urges PERAB not to propose the repeal of the LIFO inventory method.

Sincerely,

Jade West

Jade West, Senior Vice President-Government Relations
National Association of Wholesaler-Distributors
Executive Secretariat, The LIFO Coalition

Attachment:
LIFO Coalition Membership List

THE LIFO COALITION

American Apparel & Footwear Association
American Chemistry Council
American Forest & Paper Association
American Gas Association
American International Automobile Dealers Association
American Petroleum Institute
American Road & Transportation Builders Association
American Supply Association
American Veterinary Distributors Association
American Watch Association
American Wholesale Marketers Association
Americans for Tax Reform
AMT-The Association for Manufacturing Technology
Associated Equipment Distributors
Association for High Technology Distribution
Association for Hose & Accessories Distribution
Assoication of Equipment Manufacturers
Auto Team America
Automobile Dealers Association of Alabama
Brown Forman Corporation
Business Roundtable
Business Solutions Association
Caterpillar Inc.
Ceramic Tile Distributors Association
Conoco Phillips
Copper & Brass Servicenter Association
Deep South Equipment Dealers Association
Deere & Company
Far West Equipment Dealers Association
FEWA-Marketing & Distribution Association
Financial Executives International
Food Marketing Institute
Forging Industry Association
Gases and Welding Distributors Association
Healthcare Distribution Management Association
Heating, Airconditioning & Refrigeration Distributors International
Independent Lubricant Manufacturers Association
Industrial Fasteners Institute
Industrial Supply Association
International Foodservice Distributors Association
International Franchise Association
International Sanitary Supply Association
International Sealing Distribution Association
International Wood Products Association
Iowa Nebraska Equipment Dealers Association
Jewelers of America
The Manitowoc Company, Inc.
Maryland Retailers Association
MDU Resources Group
Metals Service Center Institute
Mid-America Equipment Retailers Association
Midwest Equipment Dealers Association
Minnesota Grocers Association
Minnesota-South Dakota Equipment Dealers Association
Missouri Retailers Association
Montana Equipment Dealers Association
NAMM-The International Music Products Association
National Association of Chemical Distributors
National Association of Convenience Stores
National Association of Electrical Distributors
National Association of Manufacturers
National Association of Shell Marketers
National Association of Sign Supply Distributors
National Association of Sporting Goods Wholesalers
National Association of Wholesaler-Distributors
National Auto Dealers Association
National Beer Wholesalers Association
National Electrical Manufacturers Association
National Federation of Independent Business
National Grocers Association
National Lumber and Building Material Dealers Association
National Paper Trade Alliance
National Petrochemical and Refiners Association
National Roofing Contractors Association
National RV Dealers Association
North American Equipment Dealers Association
North American Horticultural Supply Association
North American Wholesale Lumber Association
Ohio Grocers Association
Ohio-Michigan Equipment Dealers Association
Outdoor Power Equipment Aftermarket Association
Paperboard Packaging Council
Pet Industry Distributors Association
Petroleum Equipment Institute
Power Transmission Distributors Association
Printing Industries of America
Retail Industry Leaders Association
Safety Equipment Distributors Association
SBE Council
Security Hardware Distributors Association
Society of Independent Gasoline Marketers of America
SouthEastern Equipment Dealers Association
Southern Equipment Dealers Association
SouthWestern Association
Souvenir Wholesale Distributors Association
State Chamber of Oklahoma
Textile Care Allied Trades Association
Tire Industry Association
U.S. Chamber of Commerce
Wholesale Florist & Florist Supplier Association
Wine & Spirits Wholesalers of America
Wine Institute
Wisconsin Grocers Association, Inc.
Wood Machinery Manufacturers of America